REPORT TO THE SECRETARY OF THE TREASURY
FROM THE
TREASURY BORROWING ADVISORY COMMITTEE
OF THE
BOND MARKET ASSOCIATION

May 3, 2005

Dear Mr. Secretary:

Since the Committee's last meeting in February, the economic expansion has continued at a moderate pace. Real GDP grew at an annualized rate of 3.1% in the first quarter, reflecting continued growth in consumer spending, strong gains in housing, and moderating strength in business investment in equipment and software. The latest economic readings show that domestic demand has softened in the wake of higher energy costs and rising interest rates, although home buying ended Q1 at a near record pace. Notwithstanding the threat from renewed increases in energy prices, financial conditions remain supportive and along with solid profits and income gains, likely will sustain growth this year modestly above trend, on average.

Consumer spending grew by 3.5% in Q1, following an impressive 3.8% growth during 2004. Spending on durable goods stalled due in part to higher energy costs and higher interest rates. The moderation can be seen in recent downbeat earnings reports from large auto manufacturers. Higher energy costs have crimped real income gains and are limiting final demand growth temporarily. While energy costs are likely to remain elevated, gasoline prices have stopped rising for now and oil prices have retreated somewhat.

Record corporate profits have buoyed business confidence after a prolonged period of unusual caution and the effects are evident generally in more entrenched economic expansion and specifically in continued healthy growth in employment. The trend in payroll employment has remained solid, with private sector job gains averaging 160,000 per month over the past half year. While recent monthly gains have been uneven, on balance the pace of hiring has been supportive of a gradual but steady decline in the unemployment rate from 5.4% in December to 5.2% in March. Non-farm payroll growth looks to remain firm in 2005. While jobless claims rose in March, they have receded again and their four-week moving average is well below year ago levels.

Record high oil prices have heightened concern about the potential for an unfavorable mix of slower growth and higher inflation. While underlying economic growth is strong enough to overcome these higher oil prices, the Fed's Beige Book found that, "firms were able to pass at least a portion of cost increases along to their customers," highlighting the upside risks to inflation. Nonetheless, the spillover to underlying inflation has been relatively tame, the core

CPI rose at a 2.6% annualized pace in Q1, slightly faster than the 2.3% rate in Q4. The core PCE deflator increased at a 2.2% annualized pace in Q1, bringing the year-over-year change to 1.6%, up from an earlier cyclical low near 1%.

The pass-through of higher energy prices, the decline in the dollar, and gradually diminishing slack in both labor and product markets hint at a further modest pick up in core inflation. There are increased reports that businesses are successfully passing along higher energy and other raw material prices. And, the decline in the dollar already has resulted in a pick up in import prices excluding food and energy. Nonetheless, overall labor costs pressures are rising only slowly and longer-term inflation expectations have been well contained to this point and should remain so as the Fed continues to unwind accommodation.

After rising sharply ahead of the first FOMC tightening in June, 2004, long-term Treasury yields have declined by roughly 25 basis points since this tightening cycle began. As the FOMC has increased its short-term target by 200 basis points, this has led to a substantial flattening of the yield curve. The market is currently pricing in a 100% probability that the FOMC will raise rates by 25 basis points at its June meeting and is pricing in a funds rate of 3.75 % by year end.

First quarter reported operating earnings moderated from Q4 as is typical but have increased nearly 12% from a year ago. With over 80% of the S&P 500 companies having reported Q1 earnings; 80% had met or beaten expectations, while 20% had failed to meet expectations. Operating earnings have thus far surprised to the upside by 4.6% and reflect a quarter of strong earnings results. The original EPS estimate for the S&P 500 in Q1 was for 8.2% year-over-year growth vs. current expected growth of greater than 12% year-over-year. The two main contributing factors were continued strength in the oil market leading to higher Energy Sector earnings and better than expected results from the Financial Sector. After accelerating in Q4, the equity markets have declined year-to-date: the S&P 500 Index has declined approximately 4% and the NASDAQ composite has declined 11%.

The Federal budget performance on a twelve-month rolling basis has been on an improving trend, mainly reflecting both the dissipation of last year's tax cuts and solid income growth. However, ongoing military operations in the Middle East and Afghanistan caused both the CBO and the Bush administration to revise their budget numbers upwards. Still, it seems that a peak in the twelve-month rolling budget deficit is behind us, largely due to expectations of stronger employment and income growth and hence stronger tax receipts. Strong tax receipts in April make it likely that funding needs in Q2 will be less that the issues maturing during the quarter.

Against this economic and financial backdrop, the members of the Committee responded to Treasury's charge. The charge was comprised of four questions. In the initial section, a member presented charts depicting Treasury's public debt portfolio and its characteristics including average maturity of debt, steady state issuance patterns, and rollover risk. This member concluded that the Treasury liability portfolio appears to be well balanced and designed to meet Treasury's objectives while providing for flexibility for most fiscal scenarios. A concern was raised that upside surprises in budgetary deficits might force Treasury action. Treasury asked if there are other metrics that should be used to develop debt management policies. One member suggested developing other metrics of the demand function for Treasury securities. Broker/dealer technology advances could support data collection that might be useful to Treasury for better understanding trends on the demand side. Another member pointed out that increased partial duration hedging of mortgage securities has driven greater activity and demand in intermediate maturities. The Committee felt that Treasury would be well served to further study the changing long-term demand function resulting from shifts in pension investing, growth in mortgage and credit markets, as well as foreign participation trends.

In the second part of the charge, Treasury asked the Committee to describe any trends in the Treasury market that it felt are significant to Treasury as an issuer. The presenting member showed a number of slides depicting the strong demand for long duration fixed-income assets from pension funds, another showing the shortening of mortgage durations due to a higher percentage of ARM originations. The member also discussed the maturation of the TIPS market and changes to agency issuance patterns. The member discussed at length the buying patterns of both Chinese and Japanese official institutions and how their behavior had been modified. The member also discussed the explosive growth of credit derivatives markets noting that derivative contracts in some instances exceeded reference credits. Members discussed the TIPS market and most felt that it was likely to continue to improve in liquidity but concurred with the presenting member that it lacked the liquidity characteristics of nominals. Members also commented on the buying patterns of foreign central banks noting that while their preference for higher yielding fixed-income assets and equities may increase over time, they were unlikely to abruptly shift their preference for Treasuries. A member also discussed the continued strong demand for Treasuries from dealers to affect other fixed income and derivative transactions. In general, members felt that there were not apparent threatening trends afoot which might undermine demand for Treasuries.

In the third part of the charge, Treasury asked whether or not the Committee felt it should consider reintroducing 30-year bond issuance. Treasury presented a number of slides enunciating its belief that achieving the lowest cost of borrowing over time requires issuance diversification. Treasury stated a number of considerations it makes when deciding upon the maturity and amount of public borrowings, among them: optimal levels of diversification, the balance between liquid bond and short-dated issuance, effects on portfolio characteristics, issuance sizes, borrowing costs and refunding needs. Slides followed that showed the percentage of debt maturing in the next thirty-six months, distribution of marketable debt outstanding by security, and average maturities . Further, Treasury depicted several paths for the average maturity of outstandings with and without the reintroduction of 30-year bonds. Most Committee members felt that Treasury should reconsider 30-year bond issuance given a number of factors. Most members felt that given the decline in the average maturity of debt and the likelihood that it will decline further in coming years, a reintroduction would give the Treasury greater flexibility with a modest associated cost. Additionally, reintroducing 30-year bonds would serve to mitigate rollover risk given large maturities in coming years. Other members stated that given the market's familiarity with 30-year bonds, there would be little, if any, disruption and that the supply would be easily absorbed given current global and local demand dynamics. However, most members felt it important that Treasury clearly communicate its reasoning for issuance pattern changes in the context of its stated long-term objectives of achieving lowest-cost borrowing over time. Members also advised against limiting discussions of issuance changes to the 30-year bond in isolation, but rather urged Treasury to consider the full myriad of longer duration financing alternatives.

In the next section of the charge, the Committee considered the composition of marketable financing for the April-June quarter to refund $39.6 billion of privately held notes and bonds maturing May 16, 2005 as well as the composition of Treasury marketable financing for the remainder of the April-June quarter and the July-September quarter. To refund $39.6 billion of privately held notes and bonds maturing May 16, 2005, the Committee recommended a $22 billion 3-year note maturing May 15, 2008, a $15 billion 5-year note due May 15, 2010 and a $14 billion 10-year note due May 15, 2015. For the remainder of the quarter, the Committee recommended a $24 billion 2-year note issued in May, and $24 billion 2-year issued in June, a $15 billion 5-year note issued in June and $9 billion reopening of the 10-year note in June. The Committee also recommended a $20 billion 12-day cash management bill issued June 3, 2005 and maturing June 15, 2005. For the July-September quarter, the Committee recommended financing as contained in the attached table. Relevant features include three $24 billion 2-year notes, a $22 billion 3-year note, three $15 billion 5-year notes, a $14 billion 10-year note in August followed by a $9 billion reopening of that 10-year note in September. The Committee further recommended a $10 billion 10-year TIPS for issuance in July as well as an $8 billion second re-opening of the 20-year TIPS in July.

Respectfully submitted,

Ian G. Banwell
Chairman

Thomas G. Maheras
Vice Chairman

Attachments (2)